

Leoch International

Anhui operation to be improved

to summarize...

- Zhaoqing facility waiting for official approval for resumption in 2013
- Anhui facilities was to improve production rate and yield rate
- Negative impact of wastage cost on COGS and thus overall gross profit
- Continue to focus on execution and earning risk for 2012-2013F
- Remain HOLD with target price lowered to HK\$1.03 from HK\$1.15 for now

Zhaoqing facility waiting for official approval for resumption in 2013. As we have discussed in the previous note, Zhaoqing facility was under suspension for self-examination and rectification. Management indicated that Leoch is waiting for official approval for resumption of Zhaoqing facility. In the meantime, its core UPS business was affected as its Guangdong clients could not be supplied by facilities in other regions due to logistic reason. While Zhaoqing and Jiangsu were 2 major production bases in 1H, focus was shifted to Anhui and Jiansu in 2H.

Anhui facility was to improve production rate and yield rate. Upon suspension of Zhaoqing facility last year, the management was reallocating resources to Anhui facility. While previous plan involved employing as much as 7,000 staff in Anhui to catch up production, the management indicated that the company was training existing 5,800 staff is in Anhui at end of 2012. It focused on SLI segment as well as OEM contracts for telecom segment for client such as Fengfan (600482 CH) in 2H. With relatively new facility and staff, we expect Anhui to realize lower volume per staff with lower yield rate and thus higher cost including wastage cost than experienced staff in Jiansu. Table 1 shows expected production volume by various facilities in 1H and 2H 2012F. We revise down 2012F volume to 7.0m kVAh from 7.5m kVAh for 2012F; as such, 2H volume was revised down to 3.8m kVAh.

Table 1. Facilities production volume in 1H and 2H 2012F

	Anhui	Zhaoqing	Jiangsu
1H 6-month volume (kVAh)	0.2m	1.5m	1.5m
Total sales = 3.2m			
2H 6-month volume (kVAh)	2.0m	0	1.8m
Total sales = 3.8m (F)			

Source: SBI E2-Capital

Negative impact of wastage cost on COGS and thus overall gross profit. With lower yield rate in Anhui facility, wastage cost is involved. Table 2 shows revenue and gross margin for 1H and 2H 2012F. We revise down revenue to RMB1,659m on lowered volume as well as lead price. On gross profit basis, revised figure is RMB246m, which is down RMB37.4m due to lowered volume and down RMB38.6m due to increase in COGS on non-recoverable wastage up to 5.0% from 2.5%.

Table 2. Revenue and gross margin revised for 2H 2012F

RMBm	1H 2012A	2H 2012F	Prev. 2H est
Revenue	1,567	1,659	1,897
COGS	(1,261)	(1,414)	(1,574)
Gross profit	306	246	322
Net profit	71.7	10.7	65.3
Sales volume in m kVAh	3.2	3.8	4.3
Anhui non-recoverable waste	2.5%	5.0%	2.5%

Source: SBI E2-Capital

Ticker	0842 HK
Rating	HOLD
Price (HK\$)	1.34
Target Price (HK\$)	1.03 (-23%)
12m Price Range (HK\$)	0.88 - 2.69
Market cap. (US\$m)	229.5
Daily t/o (US\$m)	0.8
Free float (%)	25.1

Financial summary

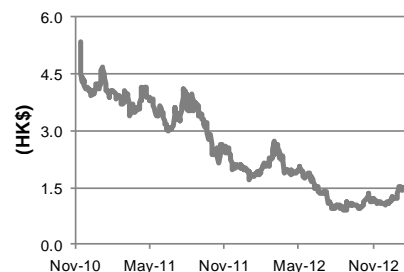
Year to Dec	10A	11A	12F	13F	14F
Turnover (RMBm)	2,117	3,164	3,226	4,500	6,090
Net Profit (RMBm)	258	284	82	266	341
EPS (RMB)	0.19	0.21	0.06	0.20	0.26
P/E (x)	4.6	4.2	17.4	5.4	4.2
P/B (x)	0.9	0.5	0.6	0.6	0.5
EV/EBITDA (x)	1.9	3.6	6.3	4.1	1.9
Yield (%)	0.0	0.0	6.6	4.6	5.9
ROE (%)	20.0	12.9	3.5	10.9	12.7
ROCE (%)	20.7	13.3	5.3	11.2	13.8
N. Gear. (%)	Cash	14.4	23.9	31.6	39.0

Source: SBI/Bloomberg

	12F	13F	14F
Consensus EPS (RMB)	-	-	-
Previous earnings (RMBm)	137	308	386
Previous EPS (RMB)	0.103	0.231	0.289

Price performance

Year to Dec	1m	3m	12m
Relative to HSI (%)	(1.5)	1.7	(38.1)
Actual price changes (%)	0.0	8.9	(29.4)



Source: Bloomberg

Kevin Mak, CFA

(852) 2533 3708

kevinmak@sbie2capital.com

Continue to focus on execution and earning risk for 2012-2013F. We continue to believe execution challenges to pressure on Leoch performance at least in short-term. Table 3 shows revision of utilization rate and gross profit per ton assumptions. For 2012F to FY12/14F, we further lowered overall utilization to between 45% and 52% on various suspension and disruption in UPS volume. At the same time, gross profit per ton for 2012F to 2014F were lowered to RMB3,150 per ton, RMB3,500 per ton and RMB3,550 per ton respectively. Sharper decline in gross profit per ton in 2012F was partly due to wastage cost we discussed and impact of equipment depreciation of largely under-utilized capacity. Upside potential lays on whether management succeeds in resuming suspended capacity and improving yield rate in the next 1-2 years.

Table 3. Utilization rate and gross profit per ton assumption lowered to reflect higher policy risk

	FY12/10A	FY12/11A	FY12/12F	FY12/13F	FY12/14F
<u>Revised estimates</u>					
Effective capacity in kWh m	5.9	9.6	15.0	23.0	28.0
Effective capacity in tonne	141,600	230,400	360,000	552,000	672,000
Utilization	71%	63%	49%	45%	52%
Shipment in tonne	100,000	145,400	175,000	250,000	350,000
Shipment growth rate	42%	45%	20%	43%	40%
Gross profit per tonne RMB	5,256	4,496	3,150	3,500	3,550
<u>Previous estimates</u>					
Effective capacity in kWh m	5.9	9.6	15.0	23.0	28.0
Effective capacity in tonne	141,600	230,400	360,000	552,000	672,000
Utilization	71%	63%	52%	47%	52%
Shipment in tonne	100,000	145,400	187,500	258,750	350,000
Shipment growth rate	42%	45%	29%	38%	35%
Gross profit per tonne RMB	5,256	4,496	3,350	3,600	3,650

Source: SBI E2-Capital

Remain HOLD with target price lowered to HK\$1.03 from HK\$1.15 for now. Table 4 shows our revised profit and loss forecast while Table 5 on the next page shows balance sheet items. Net profit for FY12/12F and FY12/13F were lowered to RMB82m and RMB266m respectively from RMB137m and RMB308m. On the other hand, while profit forecast is lowered, we lowered discount rate to 13% on lowered beta and market return. As such, target price is slightly revised lower to HK\$1.03 from HK\$1.15. Based on our new forecasts, revised target price at HK\$1.03 represents 13.3x and 4.1x P/E for FY12/12F and FY12/13F. At RMB2,337m projected FY12/12F net equity, target valuation is equivalent to 0.5x P/B. We admit this P/B valuation is low that assumed under-performance of Leoch fixed asset. We expect improvement in valuation upon better execution and earning visibility. Remain HOLD.

Table 4. Profit and loss forecast (Full-year)

RMBm	FY12/10A	FY12/11A	FY12/12F	FY12/13F	FY12/14F
Revenue	2,117	3,164	3,226	4,500	6,090
Cost of goods sold	(1,591)	(2,510)	(2,675)	(3,625)	(4,847)
Gross profit	526	654	551	875	1,243
Other income and gains	22	71	19	0	0
Selling and marketing expenses	(76)	(114)	(138)	(198)	(277)
Administrative expenses	(119)	(180)	(219)	(313)	(438)
Other operating expenses	(30)	(74)	(54)	(0)	(0)
Operating profit	322	357	159	365	529
Finance costs	(22)	(29)	(68)	(69)	(102)
Profit before tax	300	328	91	296	427
Income tax expense	(42)	(45)	(9)	(30)	(85)
Net profit	258	284	82	266	341
Reported EPS (RMB)	0.243	0.213	0.062	0.200	0.256

Source: SBI E2-Capital

Table 5. Balance sheet items

RMBm	FY12/10A	FY12/11A	FY12/12F	FY12/13F	FY12/14F
Non-current assets	638	1,847	1,681	1,816	2,023
Property, plant and equipment	521	1,230	1,474	1,592	1,776
Prepaid land lease payments	58	75	147	159	178
Non-current portion of pledged deposits	0	366	0	0	0
Other non-current assets	59	177	59	64	69
Current assets	2,446	2,405	2,847	3,095	3,924
Inventories	688	991	1,061	1,323	1,626
Trade and bills receivables	585	804	831	1,080	1,339
Prepayments, deposits and other receivables	175	159	176	193	257
Time deposit with terms over 3 months	721	0	0	0	0
Pledged deposits	67	275	105	150	210
Cash and cash equivalents	179	73	572	247	391
Other current assets	31	102	102	102	102
Non-current liabilities	0	335	4	4	4
Current liabilities	1,004	1,586	2,187	2,352	3,107
Trade and bills payables	345	548	625	746	914
Other payables and accruals	161	247	281	355	442
Bank borrowings	417	741	1,231	1,200	1,700
Other current liabilities	81	51	51	51	51
EQUITY	2,080	2,330	2,337	2,555	2,836

Source: SBI E2-Capital

SBI E2-Capital is a dedicated small/mid cap investment banking/ stockbrokerage house. Find our research on: sbie2capital.com, thomsononeanalytics.com, factset.com and multex.com

SBI E2-Capital stock ratings:**STRONG BUY** : absolute upside of >50% over the next three months**BUY** : absolute upside of >10% over the next six months**HOLD** : absolute return of -10% to +10% over the next six months**SELL** : absolute downside of >10% over the next six months

Investors should assume that SBI E2-Capital is seeking or will seek investment banking or other related businesses with the companies in this report.

Analyst certification: The views expressed in this report accurately reflect the analyst's personal views of the subject securities and that the analyst has not received and will not receive direct or indirect compensation in exchange for expressing specific recommendations or views in this report.

Disclaimer: This research report is not an offer to sell or the solicitation of an offer to buy or subscribe for any securities. The securities referred to in this report may not be eligible for sale in some jurisdictions. The information contained in this report has been compiled by the Research Department of SBI E2-Capital Financial Services Limited ('SBI E2-Capital') from sources that it believes to be reliable but no representation, warranty or guarantee is made or given by SBI E2-Capital or any other person as to its accuracy or completeness. All opinions and estimates expressed in this report are (unless otherwise indicated) entirely those of SBI E2-Capital as of the date of this report only and are subject to change without notice. Neither SBI E2-Capital nor any other person, accepts any liability whatsoever for any loss howsoever arising from any use of this report or its contents or otherwise arising in connection therewith. Each recipient of this report shall be solely responsible for making its own independent investigation of the business, financial condition and prospects of the companies referred to in this report. SBI E2-Capital and their respective officers, directors and employees, including persons involved in the preparation or issuance of this report, may from time to time (1) have positions in, and buy or sell, the securities of companies referred to in this report (or related investments); (2) have a consulting, investment banking or broking relationship with any company referred to in this report; and (3) to the extent permitted under applicable law, have acted upon or used the information contained or referred to in this report including effecting transactions for their own account in an investment (or related investment) in respect of any company referred to in this report, prior to or immediately following its publication. This report may not have been distributed to all recipients at the same time. This report is issued only for the information of and may only be distributed to professional investors and dealers in securities and must not be copied, published, reproduced or redistributed (in whole or in part) by any recipient for any purpose. This report is distributed in Hong Kong by SBI E2-Capital. Any recipient of this report who requires further information regarding any securities referred to in this report should contact the relevant office of SBI E2-Capital located in such recipient's home jurisdiction.

Copyright © SBI E2-Capital Financial Services Limited. All rights reserved.